

Section 17951-4 is amended to read:

§17951-4. Income from a Business, Trade or Profession

**Proposed deletions are identified by strikeout, proposed additions are identified by underscore.**

(a) If a nonresident's business, trade or profession is carried on entirely without the state, no portion of the ~~gross net~~ income therefrom ~~should be reported~~ is derived from sources within this state. If, on the other hand, the nonresident's business, trade or profession is conducted wholly within the state, the entire ~~gross net~~ income therefrom ~~must be reported~~ is derived from sources within this state.

(b) If ~~the a~~ nonresident's business, trade or profession is conducted partly within and partly without the state, and the part within the state is so separate and distinct from and unconnected with the part without the state ~~that the taxable income from the part within the state can be determined without regard to the part without the state such that the respective business activities are not part of a unitary business, trade or profession,~~ only the ~~gross net~~ income from the business, trade or profession within the state ~~should be reported~~ is derived from sources within this state. Thus, if a nonresident ~~operates~~ owns a hotel in California and an unrelated manufacturing business elsewhere, and is not significantly involved in the management of the hotel, ~~for example the nonresident should report only the gross net income from the hotel in California~~ is derived from sources within this state.

(c) If ~~the a~~ nonresident's business, trade or profession is a sole proprietorship which carried on within this state is an integral part of a unitary business ~~carried on both a unitary business, trade, or profession within and without the state, or if the part within the state is so connected with the part without the state that the taxable income from the part within the state cannot be accurately determined independently of the part without the state, the gross income from the entire business, trade or profession must be reported.~~ Thus, if a nonresident engaged in the business of manufacturing and selling goods, for example, maintains a factory outside this state and sales offices in this state, or vice versa, ~~the nonresident must report the gross income from the entire business. the amount of net income derived from sources within this state shall be determined in the manner described below.~~

(1) The total business income from of the unitary business sources within this state subject to the tax shall be determined by subtracting from the gross income of the unitary business those the deductions allowed by the law (see Articles 6 and 9 of Chapter 3 (Sec. Section 17201, Revenue and Taxation Code, and following)) which are attributable to that unitary business. If expenses relate to both business income and other income, the expenses shall be assigned to the respective income amounts as provided in Title 18, Cal. Code Regs., §25120(d).

(2) The amount of such business income which has its source derived from sources within in this state shall be determined in accordance with the provisions of the apportionment rules of the Uniform Division of Income for Tax Purposes Act, Sections 25120 to 25139, inclusive, Revenue and Taxation Code, and the regulations thereunder, except as otherwise provided in ~~subsection (d), below. See also subsection (g), below. subsection (f), below, for relating to special provisions pertaining to professions professional service organizations.~~ The first step is to determine which portion of the nonresident's income constitutes "business income" and "nonbusiness income" under Section 25120, Revenue and Taxation Code, and the regulations thereunder. The various items of nonbusiness are directly allocated to specific states pursuant to the provisions of Sections 25124 to 25127, inclusive, Revenue and Taxation Code. The nonresident's business income from sources within this state shall be determined by the apportionment formula provided in Sections 25128 to 25137, inclusive, Revenue and Taxation Code, and the regulations thereunder.

(3) The source of net income which is not business income shall be determined in accordance with the sourcing rules of Sections 17951 through 17955, Revenue and Taxation Code, and the regulations thereunder, and not by reference to the nonbusiness allocation rules of the Uniform Division of Income for Tax Purposes Act, Sections 25120 to 25139, inclusive, Revenue and Taxation Code, and the regulations thereunder.

~~(d) If the nonresident reports income from long-term contracts the determination of the amount of income derived from sources within this state shall be made in accordance with the method set forth in Reg. 25137.2 applicable to corporations reporting income from long-term contracts as if such nonresident were a corporation.~~

(d) If a nonresident is a partner in a partnership which carries on a unitary business, trade or profession within and without this state, the source of the partner's distributive share of partnership income derived from sources within this state shall be determined in the manner described below.

(1) Except as provided, the total business income of the partnership shall be apportioned at the partnership level in accordance with the apportionment rules of the Uniform Division of Income for Tax Purposes Act, Sections 25120 to 25139, Revenue and Taxation Code, and the regulations thereunder. Each partner's distributive share of the partnership business income apportioned to this state is income derived from sources within this state.

(2) The source of guaranteed payments received by a nonresident partner from a partnership shall be determined as if the guaranteed payments were a distributive share of partnership business income.

(3) The source of a partner's distributive share of items which do not constitute business income shall be determined in accordance with the sourcing rules of Sections 17951 through 17955, Revenue and Taxation Code, and the regulations thereunder, as if the income producing activity were undertaken by the partner in its individual capacity.

(4) Except as provided in subsection (d)(5), the business activity of a partnership will not ordinarily be considered part of a unitary business with another business activity of one or more of its partners. However, if necessary to properly reflect the income or loss of the partnership or its partners, the Franchise Tax Board shall have the discretion to treat the business activity of a partnership and a comparable business activity of one or more of its partners as part of a single unitary business, but only after conducting a comparable uncontrolled price examination in the manner provided by Section 23801(d)(1), Revenue and Taxation Code. For this purpose, the term a comparable "business activity" includes the partner's interest in the business activity of a sole proprietorship, another partnership, a limited liability company and an S corporation. If the Franchise Tax Board determines that unitary combination is appropriate under this subsection, the business income of the unitary activity shall be apportioned in accordance with the rules prescribed under subsection (5)(A), without regard to the 20 percent limitation described therein.

(5) Exception for 20 percent or more interests. Subsection (d)(4) shall not apply to partners who own, directly or indirectly, a 20 percent or more capital or profits interest in a partnership. For purposes of this section, the ownership of a capital or profits interest in a partnership shall be determined under the rules of subsection (d)(5)(B).

(A) If a partner owns a 20 percent or more interest, as described in subsection (d)(5), and the business activity of the partnership is unitary with a comparable another business activity of the partner as that phrase is described in subdivision (d)(4), the income of the unitary activity shall be combined at the partner level and apportioned to this state under the provisions of the Uniform Division of Income For Tax Purposes Act, Sections 25120-25139 inclusive, Revenue and Taxation Code, and the regulations thereunder. In determining the amount of business income apportioned to this state,

the partner shall combine the business income from unitary sole proprietorships and its distributive or pro rata shares of business income from 20 percent or more interests in unitary partnerships and S corporations. For purposes of the preceding sentence, the combined business income of a unitary partnership or S corporation shall be limited to the distributive or pro rata share of business income of the partner or shareholder from interests actually (not constructively) owned. The combined unitary business income shall be apportioned to this state under the provisions of the Uniform Division of Income for Tax Purposes Act, Sections 25120-25139, Revenue and Taxation Code, and the regulations thereunder, at the partner level. For that purpose, the partner shall aggregate its payroll, property and sales from unitary sole proprietorships and its proportionate share of payroll, property, and sales from unitary partnerships and S corporations in which the partner or shareholder owns a 20 percent or more interest to arrive at a single apportionment percentage. That percentage is applied to the combined unitary business income computed under this subsection to determine the partner's business income from sources within this state. (See Title 18, Cal. Code Regs., §25137-1(e), for rules relating to intercompany transactions between component parts of a unitary business.)

(B) For purposes of this subsection (d)(5), the actual or constructive ownership of a capital or profits interest in a partnership shall be determined in accordance with the following rules:

1. An interest in partnership capital or profits which is owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

2. An individual shall be considered as owning the interest in partnership capital or profits owned, directly or indirectly, by or for his or her family.

3. The family of an individual shall include only his or her brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, and

4. An interest in partnership capital or profits constructively owned by a person by reason of the application of subsection (d)(5)(B)1. shall, for the purpose of applying subsections (d)(5)(B)1. or (d)(5)(B)2., be treated as actually owned by such person, but an interest in partnership capital or profits constructively owned by an individual by reason of the application of subsection (d)(5)(B)2. shall not be treated as owned by him for the purpose of again applying either of such subsections in order to make another the constructive owner of such interest in partnership capital or profits.

EXAMPLE: Individual X is engaged in a sole proprietorship with business income of \$100,000. In addition, X directly owns a 15% capital interest in Partnership P. Individual X's sister Y also owns a 10% capital interest in Partnership P. Individual X's distributive share of business income from Partnership P is \$30,000, and his sister's distributive share of business income from Partnership P is \$20,000. Partnership P and X's sole proprietorship are engaged in a unitary business. Under subsection (d)(5)(B), X is treated as constructively owning Y's interest in the partnership. Thus X's aggregate owned or constructively owned interest in Partnership P is 25%. Accordingly, X is subject to the apportionment provisions of subsection (d)(5)(A). However, under subsection (d)(5)(A), Individual X will combine and apportion only the sum of his \$100,000 proprietorship income and his actual distributive share of business income of \$30,000 from Partnership P. The 20 percent test used to determine the applicability of subsection (d)(5) does not affect the amount of partnership income taken into account in computing income actually derived from sources within this state.

~~(e) If a business, trade or profession carried on within and without this state is a partnership and is of the character described in subsection (c), above, the income of the partnership attributable to sources within this state, and consequently the determination of the portion of a nonresident partner's distributive share of such income which has its source in this state shall be made in accordance with~~

~~the provisions of the Uniform Division of Income for Tax Purposes Act, Sections 25120 to 25139, inclusive, Revenue and Taxation Code, and the regulations set forth in subsection (c), above.~~

~~Thus, the amount of a nonresident partner's income from a partnership from sources within this state is determined as follows:~~

~~(1) The nonresident partner's distributive share of the various items of nonbusiness income allocated to this state, plus,~~

~~(2) The nonresident partner's distributive share of partnership business income apportioned to this state.~~

~~Example: The H-B Company is a partnership engaged in the manufacture and sale of product X within and without this state. None of H-B Company's gross business receipts is derived from conducting an extractive or agricultural business activity within the meaning of Section 25128, Revenue and Taxation Code. There are two partners, A and B. Partner A is a resident of this state and Partner B is a nonresident. The partner's distributive share of profit or loss is: A, 60% and B, 40%. Partnership profits were \$50,000 for the year of which \$45,000 was business income and \$5,000 nonbusiness income. All of the nonbusiness income is attributable to this state for purposes of this example. The partnership's income apportionment percentage for this state is determined as follows:~~

	<u>Everywhere</u>	<u>This State</u>	<u>%</u>
Property	\$400,000	\$100,000	25
Sales	300,000	75,000	25
Sales	300,000	75,000	25
Payroll	200,000	20,000	10
Apportionment percentage ( $85\% \div 4$ )			<u>85%</u> 21.25%

~~Computation of nonresident Partner B's income from sources in this state:~~

Nonbusiness income (\$5,000 x 40%)	\$2,000
Business income (\$45,000 x 40%)	\$18,000
Amount apportioned to this state (\$18,000 x 21.25%)	<u>3,825</u>
Income from sources within this state	\$5,825

(e) If a nonresident is the sole member of a limited liability company whose separate existence is disregarded for tax purposes under Section 23038, Revenue and Taxation Code, and which carries on a unitary business, trade or profession within and without this state, the source of the member's limited liability company income derived from sources within this state shall be determined in accordance with the sole proprietorship provisions of subsections (c) and (g). If a nonresident is a member of a limited liability company which is classified as a partnership for tax purposes under Section 23038, Revenue and Taxation Code, and which carries on a unitary business, trade or profession within and without this state, the source of the member's distributive share of limited

liability company income derived from sources within this state shall be determined in accordance with the partnership provisions of subsections (d) and (g). The provisions of (c), (d) or (g), as the case may be, shall not be construed to apply to the determination of "total income from all sources reportable to this state" for purposes of determining the annual fee imposed on a limited liability company under Section 17942, Revenue and Taxation Code.

(e)(f) If a nonresident is a shareholder of an S corporation (as described in Section 17087.5, Revenue and Taxation Code) which carries on a unitary business, trade or profession within and without this state, the amount of the nonresident's pro rata share of S corporation income derived from sources within this state shall be determined in the same manner as if the S corporation were a partnership. Except for subsection (d)(5)(B), the provisions of subsections (d)(1) and (d)(3) through (5) are specifically incorporated by reference. In lieu of subsection (d)(5)(B), for purposes of determining whether a nonresident shareholder has a 20 percent or more interest in an S corporation, the rules for constructive ownership of stock provided in Section 267(c) of the Internal Revenue Code shall apply. The provisions of subsection (f)(g), relating to the computation of the payroll factor for professional service organizations, shall not apply in the case of S corporations. The source of an S corporation's items of nonbusiness income for purposes of the tax imposed on the S corporation under Part 11, Division 2, Chapter 4.5 of the Revenue and Taxation Code, shall have no relevance in determining the source of items of nonbusiness income for purposes of taxing a nonresident shareholder.

(f)(g) If the nonresident a sole proprietorship or partnership described in subsections (c) or (d) is engaged in the practice of a profession within the meaning of subsection (g) below, as a sole proprietorship or as a partner in a partnership, the payroll factor of the income applicable apportionment formula prescribed in subsection (c), above, shall include 60% of the net income of a sole proprietorship or 60% of the distributive share of partnership income of each partner rendering professional personal services to the partnership. For purposes of the payroll factor the net income of a sole proprietorship and a partner's distributive share of partnership income shall consist only of income properly classifiable as business income. The amount so determined is deemed to be compensation paid to an employee for purposes of the payroll factor only. If a partner does not render professional services to the partnership, no part of such partner's distributive share of partnership income shall be taken into account in the payroll factor. The amount deemed to be compensation paid to an employee shall be included in the denominator of the payroll factor and in the California numerator of the payroll factor if the principal location of such partner is in this state.

Notwithstanding subsection (c) above, Guaranteed payments to a partner who renders professional services to a partnership engaged in the practice of a profession (within the meaning of subsection (g)(h) below) shall be treated as part of the partner's distributive share of partnership income and has a source in this state in the same manner as a distributive share properly classified as business income and shall be apportioned according to the apportionment formula of the partnership provided in Sections 25128 to 25137, inclusive, Revenue and Taxation Code, and the regulations thereunder, under subsection (d), as modified under subsection (f)(g). In computing the payroll factor of a partner who renders professional services to such a partnership and receives a guaranteed payment, 60 percent of the sum of the partner's distributive share of partnership income properly classified as business income, plus and the partner's guaranteed payment, shall be deemed to be compensation paid to an employee. The amount deemed to be compensation shall be included in the denominator of the payroll factor and in the California numerator of the payroll factor if the principal location of such partner is in this state.

EXAMPLE: The A-B-C company is a partnership performing accounting services within and without this state. There are three partners, A, B, and C. Partners A and B render professional services to the partnership. Partner C is not active in the partnership business. Partner A is a resident of this state, and Partners B and C are nonresidents. For purposes of this example, each partner's principal location is in his or her respective state of residence. The partners' distributive shares of profit or loss are: A, 50%; B, 30%; and C, 20%. In addition, Partner B receives a guaranteed payment of \$10,000.

Partnership profits after the deduction for the guaranteed payment are \$60,000 for the year. Of that amount, \$50,000 is business income and \$10,000 is nonbusiness income from a California real estate rental. All of the nonbusiness income is allocable sourced to this state for purposes of this example. The partnership's income apportionment percentage for this state is determined as follows:

	<i>Everywhere</i>	<i>This State</i>	<i>%</i>
Property	\$200,000	\$70,000	35
Sales	150,000	64,500	43
Sales	150,000	64,500	43
<u>Payroll:</u>			
Employees	56,000	21,000	
Partners:			
A- - \$50,000 x 50% x 60%	15,000	15,000	
B- - [(\$50,000 x 30%) + \$10,000] x 60%	<u>15,000</u>	<u>-0-</u>	
Total Payroll	\$86,000	\$36,000	41.86
			162.86

Apportionment percentage ( $162.86 \div 4$ )

40.72%

~~Computation of nonresident partners' income from~~

The partnership's business income from sources within this state is:

Business income (\$50,000 x 40.72%) \$ 20,360

#### Partner A

As a resident, Partner A is taxed on that partner's entire distributive share of ABC'S income, irrespective of the source of the income:

<u>A's share of partnership business income (\$50,000) x 50%</u>	<u>\$25,000</u>
<u>A's share of partnership nonbusiness rental income</u>	
<u>(\$10,000 X 50%)</u>	<u>\$ 5,000</u>
<u>A's income taxed by this state</u>	<u>\$30,000</u>

As nonresidents, Partners B and C are taxed on their distributive share of partnership income from sources within this state, determined as follows:

#### Partner B

<u>Nonbusiness income (\$10,000 x 30%)</u>	<u>\$ 3,000</u>
<u>Business income plus guaranteed payment</u>	
<u>(\$50,000 x 30%) + \$10,000</u>	<u>\$ 25,000</u>
<u>Amount apportioned to this state</u>	
<u>(\$25,000 x 40.72%)</u>	<u>\$ 10,180</u>
<u>Income from sources in this state</u>	<u>\$ 13,180</u>

<u>Partner B's share of Partnership business income from</u>	
<u>sources within this state (\$20,360 x 30%)</u>	<u>\$ 6,108</u>
<u>Partner B's guaranteed payment \$10,000 x 40.72%</u>	<u>\$ 4,072</u>

<u>Partner B's share of nonbusiness rental income</u>	
<u>(\$10,000 X 30%)</u>	<u>\$ 3,000</u>

Partner B's Income from sources within this state \$13,180

Partner C

<u>Nonbusiness income (\$10,000 x 20%)</u>	<u>\$ 2,000</u>
<u>Business income</u>	
<u>(\$50,000 x 20%)</u>	<u>\$10,000</u>
<u>Amount apportioned to this state</u>	
<u>(\$10,000 x 40.72%)</u>	<u>\$ 4,072</u>
<u>Income from sources in this state</u>	<u>\$ 6,072</u>

Partner C's share of Partnership business income from  
sources within this state (\$20,360 x 20%) \$4,072

<u>Partner C's share of nonbusiness rental income</u>	
<u>(\$10,000 X 20%)</u>	<u>\$2,000</u>

Partner C's Income from sources within this state \$6,072

~~(g)(h)~~ The practice of law, accounting, medicine or the performance of personal services in scientific and engineering discipline and the practice of any other profession in which capital is not a material income producing factor and in which more than 80% of business gross income for the taxable year is derived from personal services actually rendered by the individual or ~~the members of the partnership partners~~ shall be deemed a profession for purposes of subsection ~~(f)(g)~~ above.

~~(h)(i)~~ Rules and Definitions. To give effect to the foregoing, the following rules and definitions will be applied:

(1) Other Professions Defined. For purposes of this regulation, the term "other profession" includes any occupation or vocation in which a professed knowledge of some department of science or learning, gained by a prolonged course of specialized instruction and study, is used by its practical application to the affairs of others, either advising, guiding or teaching them, and in serving their interests or welfare in the practice of an art or science founded on it. The word profession implies attainments in professional knowledge as distinguished from mere skill and the application of knowledge to uses for others as a vocation. The performing of services dealing with the conduct of business itself, including the promotion of sales or services of such business and consulting services, does not constitute the practice of a profession even though the services involve the application of a specialized knowledge.

(2) Capital as a Material Income Producing Factor. Whether capital is a material income producing factor in the production of the income of a profession (other than law, medicine, dentistry or architecture) is to be determined by the use to which the capital is put. Ordinarily, the use of capital in a professional activity or occupation will not be considered as a material income producing factor if it is used only to defray current operating expenses such as paying salaries of assistants, rent, traveling and other incidental expenses or for investment in furniture, machines, tools and equipment essential to the carrying on of the professional activity. Capital is a material income producing factor if a substantial portion of the gross income from the occupation is attributable to the employment of capital in the business. This is ordinarily the case where substantial inventory or substantial investment in plant, machinery or other equipment is required.

(3) Gross Income Derived from Personal Services of an Individual or Partner. For purposes of determining whether more than 80% of the unincorporated business gross income is derived from personal services actually rendered by an individual or ~~by a member of a partnership or other entity engaged in the practice of an "other profession" under paragraph (1) of this subsection~~ partner, gross income from the professional practice will be deemed derived from the personal services rendered by an individual or ~~a member~~ partner if such income is personal service income as distinguished from income attributable to the sale of property or to the use of capital and such income represents fees or charges for professional services personally rendered by the individual or partner or professional fees or charges for services which are attributable to the professional activities of the individual or ~~partners~~ partner. In cases where an individual ~~or partner~~ employs assistants to perform part of the professional work, fees or charges relating to the services of the assistants will be attributed to the individual ~~or partner~~ provided the individual or ~~partner~~ (A) gives personal attention to the work of the business, (B) consults with clients or patients, (C) devises the work program, outlines work methods and guides and directs the work procedure of the employees in the activity, and (D) supervises the formulation of advice, conclusions and reports to clients or patients as the person responsible for the services performed by the business or establishment; or provided that some combination of the foregoing and/or other activities shows that the services of the employees are merely incidental to the practice of the profession by the individual ~~or partner~~. Where the profession is carried on by a ~~sole proprietorship or partnership~~, income or fees relating to work performed by employees will be attributable to ~~an individual or partner~~ members of the partnership only if, in addition to the conditions enumerated above with respect to individuals ~~or partners~~, it is shown that the clients or patients are advised ~~an individual or partner~~ by some active member of the partnership and look to ~~some active member~~ ~~an individual or partner~~ as being responsible for the services performed.

For example, where ~~an accountant or an accounting partnership or a professional engineer or a professional engineering partnership~~ employs assistants to do much of the detail work of making surveys, studies, audits, or other work ordinarily and customarily performed as an incident to the practice of the profession involved, income from professional charges based on services of the assistants will be deemed to be income derived from the services of the individual ~~or the partners~~ if ~~the individual or an active a partner member of the partnership~~ accepts the engagement or employment, supervises and directs the work, confers with clients, and prepares and edits or completes and approves the reports. Where the nature and character of the service rendered by the assistants is such that the services are rendered without any substantial control by ~~the individual proprietor or by an active a partner member of a partnership~~, such services will not be considered attributable to the individual proprietor or partner for the purposes of this subsection.

~~(i) Income from a covenant not to compete executed in connection with the sale of a business, trade or profession carried on within and without this state is income derived from sources within this state in the same ratio that business income is apportioned to this state by the business, trade or profession which was sold.~~

~~(1) For purposes of this subsection, the sale of a business, trade or profession includes all the following:~~

~~(A) The sale of the goodwill of a sole proprietorship, partnership or corporation.~~

~~(B) The sale of substantially all the assets, together with the goodwill, of a sole proprietorship, partnership or corporation.~~

~~(C) The sale or disposition by a shareholder of all of its shares in a corporation, and~~

~~(D) The sale or disposition by a partner of its entire interest in the partnership.~~

~~(2) The term covenant not to compete includes any agreement to refrain from carrying on a business, trade or profession similar to that of the business, trade or profession sold~~

~~(i)(i)~~ This regulation shall apply to taxable years beginning on or after January 1, 1976, except that the amendments to subsections ~~(c), (e) and (f)~~ (c) through (f) shall apply to the computation of taxes for taxable years of sole proprietors, partners and shareholders beginning on or after January 1, ~~1993~~ 1999. In the case of the computation of additions to tax under Section 18682, Revenue and Taxation Code, for failure to pay estimated tax, and the assessment of withholding liability and penalties under Sections 18815, 18684.2, 18685, and 19409, Revenue and Taxation Code, the amendments to subsections ~~(c), (e) and (f)~~ (c) through (f) shall apply for taxable years of sole proprietors, partners and shareholders beginning on or after January 1, ~~1994~~ 2000.

Note: Authority cited: Sections 17954 and ~~19253~~ 19503, Revenue and Taxation Code.  
Reference cited: Sections. 17041, 17951, 17854, and 25128, Revenue and Taxation Code.